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Supreme Court of the United States

OCTOBER TERM, 1954

No. 236

FANNIE HIRSHON TRUST, U/A CHARLES HIRSHON, WALTER HIRSHON, and HENRY SIEGBERT, Trustees,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioner prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit, entered May 17, 1954, reversing a decision of the Tax Court of the United States, rendered on April 3, 1953. The Tax Court had expunged a deficiency in income tax of the petitioner in the amount of $1,963.10 determined by the Commissioner for the taxable year ended December 31, 1947, and, pursuant to a recomputation for entry of decision filed on June 16, 1953, and entered by

the Tax Court on June 17, 1953, had decided that there was a deficiency in income tax of the petitioner for the taxable year 1947 in the amount of $91.81. The opinion of the United States Court of Appeals for the Second Circuit, attached as Appendix "A" to this petition, is reported at 213 F. 2d 523, 4 P-H 1954 Fed. Tax Serv. ¶72,572 (1954). The opinion of the Tax Court of the United States, in which the action was originally brought, not officially reported, is reported in P-H 1953 TC Mem. Dec. ¶53,106 (1953), and is set forth in the appendix record (R. 11a). The opinion by the Tax Court relies on its reasoning in a case involving similar facts, *Estate of Ida S. Godley*, 19 T. C. 1082 (1953), rev'd 4 P-H 1954 Fed. Tax Serv. ¶72,580 (3d Cir. 1954).

Grounds of Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit, rendered on May 17, 1954, was entered on the same day, May 17, 1954. Jurisdiction of this Court is invoked under Title 28 of the United States Code, Section 1254 (1).

Question Presented

May a corporate distribution of property to shareholders be included in their income as a distribution "out of . . . earnings or profits" of the corporation in an amount greater than the "earnings or profits" of the corporation?

Statutes and Regulations Involved

This case involves the following statutes and regulations:

Sections 115 (a), (b), (d) and (j) of the Internal Revenue Code (26 U. S. C. 1946 ed.) Sections 115 (a), (b), (d), (j)[1];

[1] All references to a statutory provision, are to the Internal Revenue Code of 1939, unless otherwise expressly specified.

Treasury Regulations 111, Section 29.115-2, promulgated under the Internal Revenue Code.

The said Statutes and Regulations are set forth in Appendix "C".

Statement of the Case

In 1947, petitioner was a shareholder of Southern Natural Gas Company (hereinafter referred to as "Southern") and received from it distributions of property and cash (R. 3a, 4a). Only the tax treatment of the property distribution is in issue.

The total value of the property distribution made by Southern to its shareholders in 1947 was $8,983,407.75 (R. 8a). The earnings or profits of Southern available for dividends in 1947 amounted to $5,674,586.32 (R. 14a). After reduction by $2,113,722.03 for the amount of the cash dividends paid (R. 8a), such earnings or profits amounted to $3,560,864.29. Accordingly, the fair market value of the property distributed to Southern's shareholders in 1947 exceeded by $5,422,543.46 the amount of earnings or profits available for dividends.

Although the property distributed in kind to Southern's shareholders had a value of $8,983,407.75, its cost to Southern was only $3,199,950 (R. 8a). Hence, the amount of earnings or profits of Southern available for dividends in 1947 (after reduction by the amount of cash dividends) exceeded the cost to Southern of the property distributed in kind.

On March 25, 1952, the Commissioner of Internal Revenue ruled that only 51.13562% of the cash and value of the property distributed to the shareholders constituted "dividend" income, and that the remainder was taxable at ordinary rates as "other income" (R. 9a-11a). A deficiency notice was issued to the petitioner on the basis of this

ruling. Thereafter, the petitioner filed a timely petition for review by the Tax Court, pursuant to the jurisdiction of said Court under Title 26 of the United States Code, Section 272.

In the Tax Court the Commissioner contended that the distributions were fully taxable as "dividends". His theory was that although Section 115(a) of the Internal Revenue Code affects *only* the *tax liability of shareholders,* it defines the term "dividend" *from the standpoint of the corporation.* Therefore, the Commissioner argued, if the earnings or profits are sufficient to absorb the cost to the corporation of the distributed property the value of the property is fully taxable to the shareholders. As an alternative, he contended that the distributions were taxable as "dividends" to the extent they did not exceed earnings or profits, and that the remainder was taxable at ordinary income rates as "other income".

The Tax Court held, with petitioner, that the amount of the "dividend" received by it in respect of the distributions by Southern was limited in amount to petitioner's proportionate share of Southern's earnings or profits, and that the excess over this amount was not "other income", but was applicable in reduction of the basis (for determining gain or loss on sale) of petitioner's Southern stock under Section 115(d) (R. 15a).

The Commissioner filed a petition for a review of the decision of the Tax Court by the Court of Appeals for the Second Circuit (R. 2a). Abandoning his theory that a portion of the distributions was taxable as "other income", he contended only that the cash, plus the entire value of property distributed to Petitioner by Southern, constituted "dividends" on the same theory as was rejected by the Tax Court. The Court of Appeals for the Second Circuit reversed the Tax Court's decision, and held that the entire value of the property distribution was tax-

able as a "dividend". A petition for rehearing was filed on August 2, 1954.

Reasons for Granting the Writ

I. This case presents important questions of Federal tax law which have not been, but should be, decided by this Court.

II. The decision below is in direct conflict with the decision of the Court of Appeals for the Sixth Circuit in *Commissioner* v. *Timken*, 141 F. 2d 625 (1944); it is irreconcilable with the decision of the Court of Appeals for the Fourth Circuit in *Timberlake* v. *Commissioner*, 132 F. 2d 259 (1942), and with the principles enunciated by this Court in *Palmer* v. *Commissioner*, 302 U. S. 63 (1937).

I

This case presents important questions of Federal Tax Law which have not been, but should be, decided by this Court.

This case involves fundamental issues in the area of taxation of corporate distributions.

The decision below came as a shocking surprise to taxpayers who with good cause thought the law well settled otherwise.[2] Over a period of ten years the Tax Court had many times held that a corporate distribution could not be taxed as a dividend beyond the amount of earnings or profits of the distributing corporation.[3] Prior to the deci-

[2] Tax Barometer, ¶871, May 22, 1954; 3 Tax Fortnighter No. 11, pp. 550-551, June 1, 1954. *See* articles at note 8, *infra*.

[3] *See* notes 6 and 7, *infra*.

sion below, only one Court had ever held to the contrary,[4] and that same Court, four months later, limited the amount taxable as a dividend to the amount of corporate earnings or profits.[5] Shortly thereafter, the Commissioner withdrew his appeals from seven Tax Court decisions which had all limited dividend treatment of corporate distributions to the amount of available earnings or profits.[6] Thus, in addition to the many decisions of the Tax Court,[7] the Commissioner's

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[4] Commissioner v. Wakefield, 139 F. 2d 280 (6th Cir. 1943). There is *dictum* in *Binzel* v. *Commissioner*, 75 F. 2d 989, 990 (2d Cir. 1935), *cert. denied*, 296 U. S. 579 (1935), consistent with failure to limit the amount of a taxable dividend to corporate earnings or profits. However, as recognized by the Court below (Appendix "A" at p. 22), there are two compelling distinctions between *Binzel* and the instant case. First, and most important, the taxpayer there completely failed to offer proof respecting the amount of corporate earnings or profits. Accordingly, the Court of Appeals held that, no matter how a property distribution is required to be measured against earnings or profits, the taxpayer had not overcome the presumptive correctness of the Commissioner's adverse determination. *See* 75 F. 2d at 989; Appendix "A" at p. 22. Second, even the *dictum* set forth a theory of "tracing" entirely different from the rationale of the decision below. *Ibid.*

[5] Commissioner v. Timken, 141 F. 2d 625 (6th Cir. 1944).

[6] Walter B. Congdon, P-H 1944 TC Mem. Dec. ¶44,188 (1944), *appeal of Commissioner dismissed on Commissioner's motion*, 150 F. 2d 1021 (8th Cir. 1945); Carl A. Fisher, P-H 1944 TC Mem. Dec. ¶44,132 (1944), *appeal of Commissioner dismissed on application of Commissioner*, 150 F. 2d 1019 (10th Cir. 1945); Henry S. McKee, P-H 1944 TC Mem. Dec. ¶44,228 (1944), *appeal of Commissioner dismissed on stip.*, 150 F. 2d 404 (9th Cir. 1945); Charles Russell McLean, P-H 1944 TC Mem. Dec. ¶44,357 (1944), *appeal of Commissioner dismissed on Commissioner's motion*, 151 F. 2d 1017 (8th Cir. 1945); Elizabeth N. Sager, P-H 1944 TC Mem. Dec. ¶44,359 (1944), *appeal of Commissioner dismissed on Commissioner's motion*, 151 F. 2d 1016 (8th Cir. 1945); Edith K. Timken, P-H 1944 TC Mem. Dec. ¶44,205 (1944), *appeal dismissed*, 5 P-H 1945 Fed. Tax Serv. ¶71,070 (5th Cir. 1945); Corinne S. Koshland, P-H 1943 TC Mem. Dec. ¶43,472 (1943), *appeal of Commissioner dismissed*, 5 P-H 1945 Fed. Tax Serv. ¶71,082 (9th Cir. 1945).

[7] The following decisions support Petitioner's position in addition to those referred to in note 6, *supra:* Jane E. Bradley, 9 T. C. 115 (1947); Paulina du Pont Dean, 9 T. C. 256 (1947), *appeal of Commissioner dismissed* 5 P-H 1949 Fed. Tax Serv. ¶71,039 (3d Cir. 1949); V. U. Young, 5 T. C. 1251 (1945), 6 T. C. 357 (1946); National Carbon Co., 2 T. C. 57 (1943), *appeal of Commissioner dismissed on stip.*, 4 P-H 1944 Fed. Tax Serv. ¶61,110 (2d Cir. 1944); Beach Petroleum Corporation, Ltd., P-H 1946 TC Mem. Dec. ¶46,192 (1946); G. W. Grandin, P-H 1945 TC Mem. Dec. ¶45,353 (1945); Howard C. Platt Trust, P-H 1945 TC Mem. Dec. ¶45,243 (1945), *appeal of Commissioner dismissed on stip.*, 154 F. 2d 1016 (9th Cir. 1946); Estate of John H. Acheson, P-H 1944 TC Mem. Dec. ¶44,392 (1944), *appeal of Commissioner dismissed on stip.*, 5 P-H 1946 Fed. Tax Serv. ¶72,356 (5th Cir. 1946); Herbert G. Hanan, P-H 1944 TC Mem. Dec. ¶44,273 (1944).

consistent failure to prosecute appeals from such decisions gave taxpayers ample grounds for the widely held belief that the law was well settled.[8]

More than 35 years after the present definition of the term "dividend" was first included in the internal revenue laws, the Commissioner advanced in this case a new theory regarding the meaning of that definition. This theory is that the extent to which a distribution is taxable as a "dividend" to shareholders must be "measured in the hands of the corporation," and that such measurement must be made in accordance with corporate law and accounting practice.[9] Measurement of the dividend "in the hands of the corporation" is completely unresponsive to the issue in this case, namely, the tax liability of shareholders. The novel approach of measuring shareholders' tax liability with reference to corporate law and accounting practice is wholly incompatible with the system of taxation of corporate distributions employed in the Internal Revenue Code. *Cf. Commissioner* v. *Wheeler*, 324 U. S. 542 (1945).

A decision so unprecedented and contrary to what was thought to be settled law amounts, in a practical sense, to a retroactive change in the law and produces obviously harsh results to the taxpayers affected. This Court need hardly be reminded of the evils of retroactivity; it has been alert to prevent them in the past in construing the tax laws. See, *e.g., Helvering* v. *Griffiths*, 318 U. S. 371, 402-403 (1943); *Claridge Apartments Co.* v. *Commissioner*, 323 U. S. 141, 164 (1944). Disastrous financial conse-

[8] Albrecht, *"Dividends" and "Earnings or Profits,"* 7 Tax L. Rev. 157 (1952); Emmanuel, *Earnings and Profits: An Accounting Concept?*, 4 Tax L. Rev. 494 (1949); Esenoff, *Difference Between Business and Tax Accounting*, Proc. of the Tax Inst. of the U. of So. Cal. School of Law 377, 390 (1951); Molloy, *Some Tax Aspects of Corporate Distributions in Kind*, 6 Tax L. Rev. 57 (1950); Rudick, *Dividends and Earnings or Profits*, 89 U. of Pa. L. Rev. 865 (1941).

[9] *See* Appendix "A" at pp. 21, 25-27, *infra*.

quences are inescapable under the retroactive impact of the theory now pursued by the Commissioner.[10]

Taxability of Distributions in Kind

The chief question presented is whether a corporate distribution in kind to stockholders may be taxed as a dividend in an amount exceeding the corporation's earnings or profits.

As will be demonstrated, the decision also directly affects the determination of gain or loss from the sale of stock in respect of which corporations at any time have made property distributions. This is true not only of sales made in tax years still open to review, but of sales which may be made in the future.

In the year of the instant distribution, the stock of the corporation involved—Southern—was held by over 10,000 shareholders. The vast majority are directly affected by the decision, as are the stockholders of other public and private corporations which have made property distributions.

Since these stockholders reside all over the country, an early decision by this Court is essential to stem the inevitable tide of litigation which will be set in motion by the decision below.[11]

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[10] For example, in *Harry Handley Cloutier*, a case now pending before the Tax Court, (T. C. Docket No. 47445) the property distributed had a value of about $1,000,000, and the distributing corporation had earnings or profits of less than $25,000. Tax counsel advised that the distribution would be taxed as a dividend only to the extent of earnings or profits. Since the distributing corporation is closely held, the treatment of the distribution as ordinary dividend income to almost the full extent of its value will result in what amounts to confiscation of the whole distribution.

[11] The taxability of the same distribution as is here involved was recently decided in the cases of *Oscar G. Thurlow* v. *U. S.*, —— F. Supp. —— (N. D. Ala., July 1, 1954), 4 P-H 1954 Fed. Tax Serv. ¶72,698, and *Mary B. Thurlow* v. *U. S.*, —— F. Supp. —— (N. D. Ala., July 1, 1954), 4 P-H 1954 Fed. Tax Serv. ¶72,699, in accordance with, and in reliance upon the decision below and the decision in *Commissioner* v. *Godley*, —— F. 2d —— (3d Cir. 1954). The same issue, involving a different distribution, was decided in accordance with the decision below in *Equitable Securities Corp.* v. *U. S.*, —— F. Supp. —— (M. D. Tenn., June 23, 1954), 5 CCH 1954 Fed. Tax Rep. ¶9530. The

Moreover, the significance of this case transcends the issues immediately involved. There are many related problems (some already in litigation) which will be illuminated, if not wholly resolved, by a review of the decision below. Some of these are:

1. What amount should be taxed as a dividend in the case of a distribution of appreciated property if the distributing corporation has no earnings or profits? This issue is presented in a case now before the Tax Court. *Michael Erburu,* T. C. Docket No. 51137. The taxpayer in the *Erburu* case is one of over 120,000 shareholders who received the distribution there in question.

2. What amount should be taxed as a dividend in the case of a distribution of appreciated property having a cost which is chargeable both to earnings or profits and to capital? This issue is presented in a case now before the Tax Court. *Harry Handley Cloutier,* T. C. Docket No. 47445.

3. What amount should be taxed as a dividend in the case of a distribution of property which has appreciated in value and which has a zero cost in the hands of the corporation, when (i) the corporation has earnings or profits, and (ii) the corporation has no earnings or profits?

4. What amount should be taxed as a dividend in the case of a distribution of cash and appreciated property, when the cost of the property and the cash together exceed the earnings or profits?

Equitable Securities case involved a corporate taxpayer, so that dividend treatment resulted in a lower tax. Accordingly, the Commissioner claimed that the amount of the dividend should be limited to earnings or profits and that the treatment of the excess of the value of the distribution over earnings or profits should be governed by Section 115(d), precisely what the petitioner is contending in this case! Thus, the Commissioner's approach to this question is apparently motivated by the needs of the revenue rather than by statutory considerations.

5. What amount should be taxed as a dividend in the case of a distribution of property which has decreased in value and which is chargeable both to earnings or profits and to capital?

6. What is the amount of the foreign tax credit under Section 131(f)(1) in respect of a dividend received in the form of appreciated property? This issue is presented in a case now before the Tax Court. *Central Aguirre Sugar Co., et al.*, T. C. Docket No. 41666.

Effect on Gain or Loss from Sale of Stock.—The treatment of the distribution in the instant case, as well as those made in the situations enumerated above (other than the last), directly affect the determination of the amount of gain or loss from the sale, at any time, of stock in respect of which a property distribution was made, as well as the question of dividend treatment at the time of the distribution. For if, as the petitioner contends, the portion of a property distribution which exceeds the corporation's earnings or profits is not a dividend, Section 115(d) requires reduction of the basis of such stock. If, on the other hand, the decision below is correct, the basis of the stock remains unaffected.

And this basis problem will arise in every sale by every taxpayer owning stock in every corporation which has ever made a property distribution to the seller in an amount exceeding the corporation's earnings or profits.

Amount Chargeable to Earnings or Profits

The decision below rests squarely upon a supposed correlation between the portion of the distribution which, as a matter of corporate bookkeeping, is charged to the earnings and profits account (as opposed to the capital account) and the amount taxable as a dividend. As above

indicated, the Court of Appeals determined that the proper charge to earnings or profits was the historical cost of the distributed property. Under this theory, if the historical cost was less than the earnings or profits, the distribution did not impair capital and the entire distribution would be "out of" earnings or profits.

Reliance upon corporate law and accounting to determine whether a distribution is "out of" earnings or profits is, in our view, clearly fallacious. "Earnings or profits" is a term of art in the tax law which has no reference whatever to ordinary corporate accounting concepts.[12]

It may be determined that there should be a correlation between the amount chargeable to earnings or profits and shareholder liability. If so, the Court below made an obviously erroneous correlation when it charged the corporation with historical cost and the shareholder with fair market value.

Taxability of the shareholder could not have been intended to depend upon the purely fortuitous circumstance of the corporation's cost for the distributed property. "Earnings or profits" in Section 115 serves the sole function of measuring shareholder, not corporate, tax liability.

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[12] The whole statutory scheme of Section 115 negates any connection between "corporate surplus" and "earnings or profits". Under Section 115(a)(2), a distribution out of current earnings or profits is a dividend, even though the corporation has a deficit. Under Section 115(d), a distribution is a return of capital if out of earnings accumulated before March 1, 1913. Under Section 115(h), a capitalization of surplus by means of a non-taxable stock dividend does not decrease earnings or profits. Nor are earnings or profits increased as a result of a gain realized by the corporation but not "recognized" under the tax laws. Section 115(l).

Compare the statement of the Court below:

> ". . . where, as here, the statutory pattern of taxation and the language used to accomplish it are both in accord with sound accounting and business practice, such an argument furnishes no ground for reading the statute otherwise than it is written. *See* Appendix "A" at p. 27.

It should be noted that the term "corporate surplus" was not used in Section 115(a). Instead, the term "earnings or profits" was employed, clearly signifying an intent that the taxation of distributions should not depend upon corporation law and accounting practice. *Cf. Commissioner* v. *Wheeler*, 324 U. S. 542 (1945), where Mr. Justice JACKSON stated:

> ". . . 'earnings or profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either" (324 U. S. at 546).

If the entire distribution is to be taxed as a dividend the more rational correlation would be to charge the corporation, as well as the shareholder, with fair market value.[13]

Whichever result is appropriate, the historical cost charge or the fair market value charge, the tax status of all future corporate distributions will be governed by the result. An authoritative decision on this point, therefore, is essential for purposes of determining the tax status of all future distributions of this and any other corporation which has ever made a distribution in kind prior to June 22, 1954.[14]

Effect of Internal Revenue Code of 1954

In the Internal Revenue Code of 1954, Congress provided, for the future, that the amount taxable as a dividend in respect of a property distribution may *not* exceed the amount of earnings or profits, regardless of whether earnings or profits are sufficient to cover the cost.[15] It also specified that the amount of charge to earnings or profits in respect of a property distribution shall be the cost of the property.[16]

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[13] Obviously this correlation was not urged by the Commissioner since it would fly in the face of what has been regarded as the corollary of the rule of *General Utilities & Operating Company* v. *Helvering*, 296 U. S. 200 (1935), to wit, that since a corporation realizes no gain upon the distribution of an appreciated asset, its earnings or profits are not increased by the unrealized appreciation. Unless earnings or profits were so increased they would be insufficient to cover the instant distribution. It would be better for the Commissioner to demonstrate his discontent with the results of the *General Utilities* case directly, instead of seeking to evade the implications of that case by recourse to irrelevant concepts of corporate accounting and by attempting to arrogate a false preeminence to Section 115(j), which is clearly subordinate and and auxiliary to Section 115(a).

[14] *See* note 15, *infra*.

[15] Section 316(a) of the Internal Revenue Code of 1954. Although the definition of "dividend" in Section 316(a) is substantially the same as that in Section 115(a) of the 1939 Internal Revenue Code, *i.e.*, a distribution "out of . . . earnings or profits," the intent of Congress to limit the amount taxable as a dividend to the amount of earnings or profits, so far as distributions under the 1954 Act are concerned, is made clear by examples in the Committee Reports. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. p. A94 (1954); Sen. Rep. No. 1622, 83d Cong., 2d Sess. p. 248 (1954)

[16] Section 312(a) of the Internal Revenue Code of 1954.

But the enactment of the new statutory rules in no way lessens the importance of a review of the instant case.

As already indicated, the decision here will affect the amount of gain or loss which will be realized on all future sales of stock in respect of which property distributions were made prior to June 22, 1954. Moreover, since the new Code again defines the term "dividend" as a distribution "out of . . . earnings or profits", the treatment of cash and property distributions made after June 21, 1954 will be directly affected by the rule, respecting the amount of charge to earnings or profits, established for property distributions made before June 22, 1954.

II

The decision below is in direct conflict with the decision of the Court of Appeals for the Sixth Circuit in *Commissioner* v. *Timken*, 141 F. 2d 625 (1944); it is irreconcilable with the decision of the Court of Appeals for the Fourth Circuit in *Timberlake* v. *Commissioner*, 132 F. 2d 259 (1942), and with the principles enunciated by this Court in *Palmer* v. *Commissioner*, 302 U. S. 63 (1937).

Conflict with Commissioner v. Timken

The decision below conflicts squarely with the decision of the Court of Appeals for the Sixth Circuit in *Commissioner* v. *Timken*, 141 F. 2d 625 (1944).

The taxpayer there received a distribution of stock which had appreciated in value while held by his corporation. In the same year he also received two cash distributions. The corporation had no accumulated earnings or

profits, but it had earnings or profits for the taxable year of the distribution.[17]

As in the present case, the taxpayer included the distributions in income to the extent of his share of the corporation's earnings or profits. As in the present case, the Commissioner claimed that the entire increase in the value of the stock distributed, although in excess of the taxpayer's share of the corporation's earnings or profits, was taxable as a dividend.

The Court of Appeals for the Sixth Circuit held for the taxpayer, limiting the amount of the dividend to the taxpayer's ratable share of earnings or profits of the year.

In the *Timken* case the amount available for dividends —the earnings or profits of the year of distribution— amounted to 88.58% of the sum of the cash and cost of the stock distributed. Thus, under the controlling regulation,[18] available earnings covered 88.58% of the cost of the property distribution.[19] Nevertheless, the Court held that *no* part of the appreciation in value was taxable as a dividend. Under the decision of the Court below in this case, however, at least 88.58% of the appreciation in value of the distributed property would have been taxable as a dividend.

The decision of the Court of Appeals for the Sixth Circuit in the *Timken* case, that the portion of the distribution

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[17] Since the enactment of the Revenue Act of 1936 (49 Stat. 1648), Section 115(a) has provided that earnings or profits for the current year, equally with accumulated earnings or profits as of the beginning of the year, constitute a source of dividends. Thus, the *Timken* case is not distinguishable from the instant case on the ground that the distribution there was out of earnings or profits of the year of distribution, rather than out of accumulated earnings or profits.

[18] U. S. Treas. Reg. 94, Art. 115-2, provides in part:

> ". . . If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year . . ."

[19] The Court below was obviously in error in dismissing *Timken* as a case in which "the cost of the property was not covered by any earnings or profits . . .". *See* note 17, *supra*, and opinion of the Board of Tax Appeals in the *Timken* case, 47 B. T. A. 494, 517 (1942).

which exceeded the stockholder's ratable share of earnings or profits was not a dividend, but instead a reduction in the basis of his stock, therefore squarely conflicts with the decision below.

Conflict with Timberlake v. Commissioner

The decision below cannot be reconciled with that of the Court of Appeals for the Fourth Circuit in *Timberlake* v. *Commissioner,* 132 F. 2d 259 (1942).

In deciding that the distribution in this case constituted a dividend in an amount exceeding the available earnings or profits, the Court below held that, as measured "in the hands of the corporation", the entire distribution was "out of" earnings or profits within the meaning of Section 115(a). It construed Section 115(a) to mean that a distribution *"out of"* earnings or profits is a distribution which, as a matter of corporate accounting, *reduces* earnings or profits in the amount of the historical cost of the property.

This very theory was rejected by the Court in the *Timberlake* case. That case involved a sale by a corporation to its shareholders of stock in another corporation; the issue was whether the sale resulted in the distribution of a dividend. The stock, although worth $150 a share, was sold to the shareholders for $100 a share. Since the stock had cost the corporation $100 a share, the sale did not diminish the corporation's surplus account.

The taxpayer in the *Timberlake* case, a shareholder, contended—consistently with the rationale below—that since the sale did not reduce earnings or profits there was no distribution "out of" earnings or profits and therefore no dividend.[20] The Commissioner—inconsistently with his

[20] "There has been no distribution of assets by the Columbia Company and its earnings or profits have not been affected by this petitioner's purchase of the Charleston Company stock." *Brief for Taxpayer,* p. 23. *See also* the Board of Tax Appeals opinion in this case, 46 B. T. A. 1082, 1087.

position below and with the decision below—countered that "it is immaterial . . . that the book surplus of the [distributing] Company was not affected by the sale of the . . . stock."[21]

The Court of Appeals for the Fourth Circuit, affirming the determination of the Board of Tax Appeals, held that the $50 excess of the fair market value of the stock over the price paid by the shareholders constituted a dividend, because there were available earnings or profits in that amount.

Since the distribution in the *Timberlake* case resulted in no such reduction in earnings or profits, the decision there necessarily rejected the theory of the decision below that the taxability of a property distribution to shareholders depends on the extent of the reduction of earnings or profits prescribed under corporate accounting practice.

Conflict with Palmer v. Commissioner

The decision of the Circuit Court below cannot be reconciled with the principles enunciated by this Court in *Palmer* v. *Commissioner*, 302 U. S. 63 (1937).

Like the *Timberlake* case, the *Palmer* case presented the question whether a corporate sale of property to stockholders, at a price less than fair market value, but not less than cost to the corporation, resulted in a dividend. Unlike the *Timberlake* case, however, the price at which the property was offered in the *Palmer* case equalled its value at the time of the offer. (The property increased in value between the date of the offer and the actual sale.)

This Court held that because the offering price and value were equal, the corporation had not distributed a dividend. Mr. Justice STONE wrote:

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[21] *See Brief for Commissioner* in the *Timberlake* case, p. 19.

> "We think that a distribution of assets by a corporation to its stockholders by means of a sale, to which it is committed by appropriate corporate action at a time when their sale price represents their reasonable value, is not converted into a dividend by the mere circumstance that later, at the time of their delivery to stockholders, they have a higher value." (302 U. S. at 71)

Clearly, however, if value had exceeded price at the time of the offer, this Court would have held that there had been a dividend:

> "On the other hand such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend." (*id.* at 69).

This latter statement foreshadowed the decision of the Court of Appeals for the Sixth Circuit in the *Timberlake* case; indeed it formed the basis for that decision. Clearly, therefore, the principles enunciated by this Court in the *Palmer* case, as is the decision in the *Timberlake* case (*see* pp. 15-16, *supra*), are irreconcilable with the decision of the Second Circuit in the instant case.

CONCLUSION

Petitioner prays that a Writ of Certiorari issue to the United States Court of Appeals for the Second Circuit to review its judgment.

Respectfully submitted,

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JOHN P. ALLISON,
Attorneys for Petitioner.

RAYMOND RUBIN,
Of Counsel.

August 13, 1954.

[APPENDICES FOLLOW]

APPENDIX "A"

The following is the full text of the opinion of the Court of Appeals of the Second Circuit in the instant case:

"HARLAN, *Circuit Judge*:

The question raised by this petition is the extent to which the fair market value of a corporate distribution in kind is taxable to the shareholder-distributees as ordinary dividend income where the earnings and profits of the distributing corporation are sufficient to cover the adjusted cost of the property distributed but are insufficient to cover its full market value at the time of the distribution.

In 1947, Southern Natural Gas Company (hereinafter called "Southern") distributed as dividends to its shareholders (of whom Respondent was one) $2,113,722.03 in cash and 1,409,162 shares of common stock of Southern Production Company, Inc. (hereinafter called "Southern Production"), a wholly owned subsidiary of Southern. The Southern Production stock had an adjusted cost value on Southern's books of $3,199,950. Its fair market value at the time of distribution was $8,983,407.75. Southern had earnings or profits before these distributions amounting to $5,674,586.32. The respondent taxpayer's proportion of these distributions amounted to $12,680.62, of which $2,416.87 represented its share of the cash distribution and $10,263.75 its share of the distribution payable in Southern Production stock, taken at market value.

In reporting these distributions in its federal income tax return for 1947, the taxpayer proceeded on the premise that the market value of the Southern Production stock was taxable to Southern's shareholders as dividend income *only* to the extent of Southern's earnings and profits, determined *without regard* to any appreciation in the value of Southern Production stock above its adjusted cost basis

on Southern's books. The Commissioner, however, ruled that the Southern Production stock was taxable to Southern's shareholders as ordinary income to the full extent of its fair market value at the time of receipt, and accordingly determined that the taxpayer had understated its income for 1947. The Tax Court sustained the taxpayer's position, holding that the market value of Southern Production stock in excess of Southern's earnings and profits, as computed on the basis of its adjusted cost on Southern's books, was applicable first to reduce the basis of the shareholders' Southern stock and beyond that was taxable as a capital gain as provided in § 115(d).

The controlling sections of the Internal Revenue Code are § 22(a) and (e), 26 U. S. C. § 22, and § 115(a), (b), (d) and (j), 26 U. S. C. § 115. Their relevant portions are printed in the margin.[1]

The taxpayer's position is that the provisions of § 115(a), defining a dividend as any distribution made by a corporation "out of its earnings or profits accumulated

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[1] Section 22. Gross income

"(a) *General definition.* 'Gross income' includes gains, profits, and income derived from * * * dividends, * * * or gains or profits and income derived from any source whatever. * * *"

"(e) *Distributions by corporations.* Distributions by corporations shall be taxable to the shareholders as provided in section 115."

Section 115. Distributions by corporations

"(a) *Definition of dividend.* The term 'dividend' when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913 * * *"

"(b) *Source of distributions.* For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof * * *"

"(d) *Other distributions from capital.* If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *"

"(j) *Valuation of dividend.* If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

after February 28, 1913," also measure the extent to which a distribution in kind is subject to dividend taxation in the hands of the shareholders, that is that the market value of the property distributed is not taxable as "dividend" income beyond the extent of the corporation's "earnings or profits," any excess value being subject to a different kind of tax treatment as held by the Tax Court.

More specifically, the taxpayer contends that after eliminating from Southern's "earnings or profits" the cash dividends of $2,113,722.03, which are concededly taxable to Southern's shareholders as ordinary income to their full extent, the value of the Southern Production stock ($8,983,407.75) is taxable as a dividend only to the extent of Southern's remaining "earnings and profits," *viz.*, $3,560,864.29. The remaining value of the Southern Production stock, $5,422,543.46, it is contended, is subject to the other tax treatment indicated above.

The Commissioner's position is that all that is excluded from individual income taxation under § 115 are distributions to shareholders which impair the capital of the distributing corporation. In essence his argument is that we should distinguish between the value of an asset in the hands of the corporation for the purpose of determining surplus or capital impairment, and the value of the asset for tax purposes when distributed to the shareholders. In the first aspect, so the Commissioner argues, the value of the asset is its historical cost to the corporation, without regard to any subsequent appreciation in value; in the second aspect, the worth of the asset is its full market value at the time of receipt by the shareholders; and under the statute there is no necessary *money* correlation between these two sets of values. Therefore, it is contended, once it is shown that a distribution in kind has left the corporate capital intact, the distribution is "out of" the corporation's "earnings or profits," and hence a dividend under § 115(a), which under § 115(j) becomes taxable to the shareholders to the full extent of its market value at the time of receipt.

More specifically, the Commissioner contends that Southern's earned surplus ($5,674,586.32) being greater than the total value ($5,313,672.03) of the distributed cash and Southern Production stock (at its adjusted cost to Southern), the entire distribution constituted a dividend, and as such the part represented by Southern Production stock, equally with the cash part, was taxable as ordinary income to the full extent of its fair market value, *viz.*, $8,983,407.75.

We are thus called upon to decide between these two opposing views of the taxing pattern established by § 115. The decisions of the Tax Court have fairly consistently supported the taxpayer's position. *Estate of Godley* v. *Comm'r*, 19 T. C., No. 124 (1953), relating to the identical distributions here involved, and upon which the decision below was based; *Pauline du Pont Dean* v. *Comm'r*, 9 T. C. 256 (1947); *Estate of Acheson*, 3 T. C. M. 1242 (1944); and in its result *Beach Petroleum Corp.* v. *Comm'r*, 5 T. C. M. 638 (1946).

The cases in the Federal Courts, however, do not give us any clear signal. In *Binzel* v. *Comm'r*, 75 F. 2d 989 (2d Cir.), *cert denied* 296 U. S. 579 (1935), relied on by the Commissioner, it did not appear whether there was sufficient surplus to cover the full market value of the distribution in kind. If there was, then that case did not reach the issue before us. If there was not, we would hesitate to accept the alternative basis for decision, namely, that the distributed property was *acquired* out of post-1913 earnings or profits and retained that character upon distribution. See Paul, *Selected Studies in Federal Taxation*, 2d Series (1938), pp. 174-176; Molloy, *Some Tax Aspects of Corporate Distributions in Kind*, 6 Tax L. Rev. 57, 74-76 (1950). For the same reason we find *Comm'r* v. *Wakefield*, 139 F. 2d 280 (6th Cir. 1943), also cited by the Commissioner, not persuasive. The concurring opinion of Judge WHITAKER in *Guinness* v. *United States*, 73 F. Supp. 119

(Ct. Claims 1947) *is* an acceptance of the Commissioner's position, but the decision of the majority went upon other grounds, based on facts not involved here. In *Comm'r* v. *Timken Estate*, 141 F. 2d 625 (6th Cir. 1944), cited by the taxpayer, a dividend in kind was held not taxable as income to the stockholder, but there the *cost* of the property distributed was not covered by any earnings or profits (which had been exhausted by prior cash dividend distributions), and in effect constituted a distribution of *capital*.

We also consider the legislative history of § 115, which has been referred to in the respondent's brief, wholly unclear. Finally, we find tax lawyers, who have written on the subject, on both sides of the question. See Paul, *Selected Studies, etc., supra*, 165-185, and *Raum, Dividends in Kind: Their Tax Aspects*, 63 Harv. L. Rev. 593-609 (1950).

We turn then to examine the provisions of the Internal Revenue Code themselves. Section 22(a) defines "gross income" to include "dividends * * * or gains or profits and income derived from any source whatever." No contention is made here that the Southern Production stock constituted "income" to Southern's shareholders otherwise than as a "dividend." Section 22(e) provides that corporate *distributions* are taxable to the shareholders as provided in § 115. So far as here relevant, §115(a) defines a *dividend* as "any distribution made by a corporation to its shareholders, *whether in money or in other property*,[2] out of its earnings or profits accumulated after February 28, 1913 * * *."

Both parties here agree with the premise of the Tax Court in the *Godley* case, citing *General Utilities & Operating Co.* v. *Helvering*, 296 U. S. 200 (1935), that under §115(a) unrealized appreciation in corporate assets may not be reckoned in "earnings or profits"; or, as the Commissioner puts it, in computing "earnings or profits"

[2] Italics, wherever used in this opinion, have been supplied.

corporate assets are to be taken at historical cost. Cf. *R. D. Merrill Co.* v. *Commissioner,* 4 T. C. 955 (1945), wherein the Tax Court held that in determining to what extent a distribution made in the stock of another corporation, which had *depreciated* in value below its cost to the distributing corporation, reduced earnings and profits available for later distributions, the earnings and profits of the distributing corporation should be charged with the *cost* of the stock rather than merely its depreciated value. The "capital impairment" statutes of some states permit unrealized appreciation to be calculated in determining corporate surplus available for dividends [*e.g.,* § 58, N. Y. Stock Corp. Law, *Randall* v. *Bailey,* 288 N. Y. 280 (1942)]. Other states, perhaps more in keeping with sound accounting and business practice, do not permit unrealized appreciation to be counted in computing corporate surplus, in determining which the corporate assets are to be reckoned at their historical cost. *E.g.,* Ill. Rev. Stats. 1951, C. 32, § 41(c); Penn. Stats., Tit. 15, §§ 2852-701A(1), 702 (Purdon 1936). If the matter be still open under the *General Utilities* case, *supra,* we agree with the Tax Court's conclusion in this respect, and think it is this latter view which Congress has adopted in § 115(a).

To continue with § 115, Section 115(b) entitled "Source of Distributions" states that "every *distribution* is made out of earnings or profits to the extent thereof * * *." Section 115(d), entitled "Other Distributions from Capital" provides that if "* * * any distribution * * * is not a dividend * * *" it shall be applied to reduce the basis of the shareholders' stock in the distributing corporation, and any excess shall be taxable as a capital gain. And finally § 115(j) provides: "If the whole or any part of a *dividend* is paid to a shareholder in any medium other than money the property received other than money *shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.*"

As we see it, the real nub of the dispute between the taxpayer and the Commissioner comes down to the question of whether, as the taxpayer contends § 115(a) defining dividends as those corporate distributions which are made "out of earnings or profits," also measures the amount of a distribution in kind which is subject to ordinary income taxation as a dividend under § 115(j). The taxpayer's position is, in effect, that since under § 115(a) unrealized appreciation in the value of the property to be distributed is to be excluded in measuring the corporation's earnings or profits for the purpose of determining the extent to which the distribution is a dividend, likewise unrealized appreciation should be excluded in determining how much of the distribution is subject to ordinary income taxation as a dividend. The taxpayer achieves what it claims to be the proper result by applying the amount of the earnings or profits of the corporation against the *appreciated* value of the distributed property, and treating any excess in such value as a capital distribution rather than a dividend.

We do not think that the taxpayer's position withstands analysis. Fundamentally, it involves measuring a dividend distribution for taxation purposes differently from the way Congress has defined a dividend. Thus, as we have seen, in determining whether the distribution of an asset in kind is a dividend under § 115(a) the earnings and profits of the corporation are charged with the *cost* of the asset to be distributed, without regard to any unrealized appreciation in its value. Yet when it comes to determining the nature of the distribution from the point of view of its taxability the taxpayer would have us charge the same asset against the corporate earnings or profits at its *appreciated value.* But surely the *nature* of a distribution under § 115 is not so elusive. If a distribution is a dividend when declared by the corporation, it is difficult to see how it can in part be something else when received by the stockholders. Stated otherwise, if corporate earnings and profits are to be *charged* with the appreciated

value of a distributed asset, we think they should also be *credited* with that value. But if that were done here the problem we have would disappear. It is only by measuring the extent of the dividend differently in the hands of the shareholders from the way in which § 115(a) requires it to be measured in the hands of the corporation, that the taxpayer has a case.

No doubt Congress could have enacted two such different standards of measurement, but we do not think that it has done so, and we are left unpersuaded by the taxpayer's arguments to the contrary. We are referred to § 115(b) which provides that "every distribution is made out of earnings or profits to the extent thereof." But we think that all that this means is that any corporate distribution not *made* in the form of a dividend declaration is nonetheless to be regarded as such to the extent that it represents the earnings or profits of the corporation.

The taxpayer also argued that § 115(d) prescribing capital gains treatment for any distribution which "is not out of increase in value of property accrued before March 1, 1913, *and is not a dividend,*" embraces in that treatment the unrealized appreciation of a distribution in kind which exceeds the earnings or profits of the corporation before such distribution. However, we think that § 115(d), as its caption "Other Distributions from Capital" indicates, is rather designed to subject to capital gains taxation those distributions which have left the capital of the corporation impaired. And concededly these distributions did not have that result. Indeed § 115(d) seems to us to support the position of the Commissioner rather than that of the taxpayer.

The contention of the taxpayer encounters, we think, an insuperable obstacle in § 115(j) which requires a stockholder to include in his gross income the whole or any part of a dividend paid in property "at its full market value at the time as of which it becomes income to the share-

holder." No argument is made that a dividend in kind does not become income to the shareholder until its value is realized by sale or other disposition. Cf. *Messer.* v. *Comm'r,* 20 T. C., No. 31 (1953); *Helms Bakeries* v. *Comm'r,* 46 B. T. A. 308 (1942). All that the taxpayer argues is that this section was designed to settle merely the *time* at which a property dividend is to be valued for income tax purposes. We cannot accept so limited a construction of § 115(j). Rather, we think that § 115(j) removes whatever doubt there might otherwise be that dividends in kind, as defined in § 115(a), are taxable as *dividends* to the full extent of their market value at the time of receipt by the shareholders.

Finally, the taxpayer, conceding that the accounting practices underlying the Commissioner's position "may be impeccable," argues that there is frequently a divergence between the tax laws and generally accepted business concepts. That may be true, but where, as here, the statutory pattern of taxation and the language used to accomplish it are both in accord with sound accounting and business practices, such an argument furnishes no ground for reading the statute otherwise than it is written. The taxpayer's error, it seems to us, stems from attempting to tie the factors applicable to determining the *nature* of the distribution to its *valuation* after its nature has been determined. The appreciated value of the Southern Production stock was not, nor was it required to be, a distribution "out of" Southern's earnings or profits—it was simply a distribution *of* that appreciation which was not a part of Southern's earnings or profits or of its capital.

We hold that the Southern Production stock was taxable to the respondent at its full market value at the time of receipt.

Reversed."

APPENDIX "B"

Judgment of the Court Below

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the 17th day of May one thousand nine hundred and fifty-four.

Present:

HON. CHARLES E. CLARK,
HON. CARROLL C. HINCKS,
HON. JOHN M. HARLAN,
Circuit Judges.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

FANNIE HIRSHON TRUST, U/A CHARLES HIRSHON, WALTER HIRSHON and HENRY SIEGBERT, Trustees,
Respondents.

Appeal from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is reversed.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

/s/ A. DANIEL FUSARO,
Clerk.

APPENDIX "C"

Statutes and Regulations Involved

Internal Revenue Code:

26 U. S. C. 1946 ed., Sec. 115:

"§ 115. *Distributions by corporations*

"(a) *Definition of Dividend.*—The term 'dividend' when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . ."

• • • • •

"(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113 . . ."

"(d) *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same man-

ner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f)(1), is not treated as a dividend, whether or not otherwise a dividend."

• • • • •

"(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

• • • • •

Treasury Regulations 111, Section 29.115-2

"Sources of Distributions in General.—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first,* to the earnings or profits of the taxable year; *second,* to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third,* to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and *fourth,* to sources other than earnings or profits only after the earnings or profits have been distributed.

If the earnings or profits of the taxable year (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of earnings or profits at the time of the distribution) are sufficient in amount to cover all the

distributions made during that year, then each distribution is a taxable dividend. (See section 29.115-1.) If the distributions made during the taxable year exceed the earnings or profits of such year, then that proportion of each distribution which the total of the earnings or profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings or profits of that year. The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. The provisions of this section may be illustrated by the following example:

Example. At the beginning of the calendar year 1942, the M Corporation had $12,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for 1942 amounted to $30,000. During the year it made quarterly distributions of $15,000 each. Of each of the four distributions made, $7,500 (that portion of $15,000 which the amount of $30,000, the total earnings and profits of the taxable year, bears to $60,000, the total distributions made during the year) was paid out of the earnings and profits of the taxable year; and of the first and second distributions, $7,500 and $4,500, respectively, were paid out

of the earnings and profits accumulated after February 28, 1913, and prior to the taxable year, as follows:

Distributions During 1942		Portion out of Earnings or Profits of the Taxable Year	Portion out of Earnings Accumulated Since Feb. 28, 1913, and Prior to Taxable Year	Taxable Amount of Each Distribution
Date	Amount			
March 10....	$15,000	$7,500	$7,500	$15,000
June 10.....	15,000	7,500	4,500	12,000
September 10	15,000	7,500	—	7,500
December 10	15,000	7,500	—	7,500
Total amount taxable as dividends.....				$42,000

Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of chapter 1."

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In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 286

FANNIE HIRSHON TRUST, U/A CHARLES HIRSHON, WALTER HIRSHON, AND HENRY SIEGBERT, TRUSTEES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 11a-15a) are not officially reported. The opinion of the Court of Appeals (Pet. App. 19-27) is reported at 213 F. 2d 523.

JURISDICTION

The judgment of the Court of Appeals was entered on May 17, 1954. (Pet. App. 28.) The peti-

tion for a writ of certiorari was filed August 16, 1954. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Whether the entire fair market value of a corporate distribution of property in kind to stockholders is taxable to the stockholders as a dividend under Section 115 of the Internal Revenue Code where the distributing corporation's earnings and profits (without increase in the amount of the appreciation in value of the distributed property) are more than sufficient to cover the adjusted cost of the distributed property to the distributing corporation but are not sufficient to cover the full fair market value (cost plus appreciation in value) of the property at the time of the distribution.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * dividends, * * * or gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution

shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(d) [as amended by Sec. 214 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f)(1), is not treated as a dividend, whether or not otherwise a dividend.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

STATEMENT

The facts, as stipulated and as found by the Tax Court (R. 12a-15a), may be summarized as follows:

The taxpayer is a trust which was created on December 31, 1917, by Charles Hirschhorn (later known as Charles Hirshon). Charles Hirshon, Walter Hirshon and Henry Siegbert are its duly qualified and acting trustees. (R. 12a.)

During 1947 the taxpayer-trust owned and held shares of the capital stock of Southern Natural Gas Company (hereinafter called Southern), a Delaware corporation which operates an interstate natural gas pipeline system and has its principal offices at Birmingham, Alabama. As its proportionate share of distributions made by Southern to its stockholders in 1947, the taxpayer-trust received cash distributions in the total amount of $2,416.87 (consisting of distributions at the rate of 37½ cents a share on the 12th days of March, June, September and December 1947) and 1,610 shares of common stock of Southern Production Company (hereinafter called Southern Production) having a fair market value of $10,263.75 ($6.375 a share) on July 28, 1947, the date of the distribution. (R. 12a-13a.)

Of the total amount of $12,680.62 represented by the cash and the fair market value of the stock received as dividends from Southern, the taxpayer-trust in its 1947 income tax return reported as taxable income only $6,112.64, of which $1,519.85 was

treated as distributable income taxable to Fannie Hirshon, the beneficiary of the taxpayer-trust, and hence not taxable to the trust. The Commissioner determined a deficiency against the trust on the ground that it had understated its dividend income from Southern by $6,567.98.[1] Concededly, $1,519.85 of the $12,680.62 received by the trust from Southern in 1947 is distributable income of the trust taxable only to Fannie Hirshon. (R. 14a-15a.)

The total distributions made by Southern to its stockholders in 1947 amounted to $2,113,722.03 in cash and 1,409,162 shares of the common stock of Southern Production. The Southern Production stock had an adjusted cost basis in Southern's hands of $3,199,950 and a fair market value at the time of distribution of $8,983,407.75. (R. 14a.)

In declaring the Southern Production stock as a dividend in kind, the board of directors of Southern directed that the cost of that stock to the company be charged to earned surplus on the company's books of account. On its books Southern in 1947 charged earned surplus with $2,113,722.03 as repre-

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[1] Taxpayer is incorrect in stating (Pet. 3-4) that the Commissioner's deficiency notice was issued on the basis of a prior ruling that 51.13562 per cent of the cash and value of the distributed property constituted "dividend" income and that the remainder was taxable at ordinary rates as "other income". The deficiency notice, contained in the original record in the Tax Court but not printed on appeal, stated in its Preliminary Statement that—

> The cause for the deficiency is the taxability of a dividend which was considered non-taxable by the taxpayer.

and in its Explanation of Items explained the $6,567.98 addition to reported income as—

> Dividend paid on 1610 shares of Southern Natural Gas Co. stock originally considered as non-taxable.

senting the cash distributed as dividends during the year and $3,199,663.55 as representing the cost to it of the Southern Production stock distributed as a dividend. After making such deductions, Southern's book earned surplus was $12,356,597.65. (R. 14a.)

Southern had $5,674,586.32 of earnings and profits available for distribution as dividends in 1947. (R. 14a.) Its 1947 cash distributions reduced those earnings and profits to $3,560,864.29. That amount was more than the adjusted cost ($3,199,663.55) to Southern of the stock which it distributed to its stockholders in 1947 but was less than the fair market value ($8,983,407.75) of such stock.

In interpreting and applying Section 115 of the Internal Revenue Code, the Tax Court, on the authority of its prior decision in *Estate of Godley* v. *Commissioner,* 19 T.C. 1082, held that the $8,983,-407.75 fair market value of the distributed stock (cost plus the appreciation in value) should be charged against Southern's earnings and profits (without increase in the amount of the appreciation in value) in determining to what extent the fair market value of the distributed stock constituted a dividend to the stockholders. The result was a holding that the $8,983,407.75 fair market value of the distributed stock is taxable to the stockholders as a dividend only to the extent of Southern's earnings and profits of $3,560,864.29 remaining after deduction of the amount of Southern's 1947 cash distributions. (R. 15a.) The Court of Appeals reversed the Tax Court, holding that the cost basis of the distributed stock, rather than its

fair market value, should be charged against Southern's earnings and profits in determining the extent to which the distributed stock constituted a dividend and that, since Southern's earnings and profits were more than sufficient to cover such cost basis, the entire stock distribution constituted a dividend on which the stockholders are taxable at fair market value. (Pet. App. 20-27.)

ARGUMENT

1. The decision below and *Commissioner* v. *Godley's Estate,* 213 F. 2d 529 (C.A. 3d), in which a petition for a writ of certiorari is also pending (No. 305, October Term, 1954), involve the identical corporate distribution. Both courts independently reached the same result, and that result is clearly correct.

Under Section 115 (j) of the Internal Revenue Code, *supra,* p. 4, the amount of a "dividend" in property other than money is measured from the standpoint of the distributee-shareholders and with reference to the fair market value of the distributed property. However, as the court below held (Pet. App. 25-27) and the Third Circuit succinctly stated in the *Godley's Estate* case (p. 533), Section 115 (a), *supra,* p. 3, which defines a "dividend" as a distribution of money or other property "out of" earnings and profits (as distinguished from a distribution out of capital, covered by subsection (d), *supra,* p. 4), requires that the character of a distribution as a "dividend" be determined from the standpoint of the distributing corporation. Any distribution of money or property to shareholders

must first be applied against earnings and profits. Section 115 (b), *supra*, pp. 3-4. When a corporation distributes to its shareholders property which has appreciated in value, the charge against the corporation's net worth (first earnings and profits) is necessarily the amount of the reduction in the corporation's net worth by reason of the distribution. The reduction in net worth is only in the amount of the cost basis of the property, for the amount of the appreciation in value (which represents the difference between the cost basis and the fair market value of the property) is never added to the corporation's net worth.[2] Since the cost basis of the property distributed by Southern in 1947 was completely covered by earnings and profits, the property constituted a dividend *in toto* (taxable to

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[2] The amount of the appreciation in value is not realized by the corporation by reason of the distribution of the property to its shareholders (*General Utilities Co.* v. *Helvering*, 296 U. S. 200) and the distribution therefore does not increase the corporation's earnings and profits in the amount of the appreciation in value (cf. *Commissioner* v. *Wheeler*, 324 U. S. 542).

The arithmetic calculation of the effect on the amount of the corporation's earnings and profits prior to the distribution would be different but the ultimate result would be the same if the appreciation in value were treated as realized by the distributing corporation. If distribution of the property resulted in a realization of income by the corporation in the amount of the appreciation in value, the distribution would cause a simultaneous increase and decrease in earnings and profits in the amount of the appreciation in value and the *fair market value* of the distributed property could properly be charged against earnings and profits *as increased* in the amount of the appreciation in value, with the result that the amount of earnings and profits which the corporation had prior to the distribution would be reduced only by the *cost* of the distributed property. As the Sixth Circuit stated in the *Godley's Estate* case (p. 533), "cost is the only real variant".

the shareholders at fair market value), as the court below held. See also *Commissioner* v. *Godley's Estate,* 213 F. 2d 529 (C.A. 3d); concurring opinion of Judge Whitaker in *Guinness* v. *United States,* 73 F. Supp. 119 (C. Cls.), certiorari denied, 334 U.S. 819; *R. D. Merrill Co.* v. *Commissioner,* 4 T.C. 955, 959-963; cf. *Reynolds Spring Co.* v. *Commissioner,* 181 F. 2d 638 (C.A. 6th).

The taxpayer's criticisms of the decision below (Pet. 7, 10-11) are without basis. Taxpayer asserts that the reduction in the distributing corporation's net worth (first earnings and profits) should be correlated in terms of *money* with the fair market value on which the shareholders are taxable (Pet. 11-12). No such correlation is possible in a situation where, as here, the distributing corporation does not realize the amount of the appreciation in the value of the distributed property, since Section 115 requires that the character of the distribution be determined from the standpoint of the distributing corporation and the taxable amount thereof from the standpoint of the shareholder receiving it. Taxpayer also asserts that the court below improperly based its decision on corporate law and accounting in holding that earnings and profits are chargeable only with the cost basis of the distributed property (Pet. 10-11). To charge earnings and profits with the cost basis, rather than the fair market value, of the distributed property is in accord with Southern's own action (see Statement, *supra,* p. 6) and apparently with sound accounting and business practices, as the court below indicated. (Pet. App. 24.) However, the de-

cision below was based upon an application of Section 115 consistently with the fact that *taxwise* a distribution of appreciated property to shareholders does not result in a realization of income by the corporation in the amount of the appreciation in the value of the property. As the court below stated (Pet. App. 27), the statutory language cannot be read otherwise than it is written merely because the statutory pattern and language used to accomplish it are in accord with sound accounting and business practices.[3]

2. Contrary to taxpayer's assertions (Pet. 13-17), the decision below is not in conflict with *Commissioner* v. *Timken*, 141 F. 2d 625 (C.A. 6th), nor irreconcilable with *Timberlake* v. *Commissioner*, 132 F. 2d 259 (C.A. 4th), or the principles enunciated in *Palmer* v. *Commissioner*, 302 U.S. 63. None of those cases involved the question of the proper charge to be made against earnings and profits by reason of a property distribution to shareholders.

In *Timken*, which involved a property distribution made in 1936, the distributing corporation's earnings and profits consisted solely of current earnings and profits of $247,011.94 for 1936. In that year the corporation distributed the full amount thereof to its shareholders in cash ($200,000 on July 7, 1936, and $48,000 on December 28, 1936)

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[3] Taxpayer states that earnings and profits are not the same as book earned surplus or taxable income (Pet. 11), but that is merely to say, in effect, that under Section 115 a determination of whether a distribution constitutes a dividend must be made with reference to a statutory concept of earnings or profits and capital.

and, in addition, property which had cost the corporation $30,857.14 and had a fair market value of $154,500 at the time of distribution on July 8, 1936. The Sixth Circuit held, first, that the property distribution was a distribution of capital, rather than a dividend, because at the time of the distribution the corporation had no earnings and profits to distribute. Secondly, the court rejected the Commissioner's argument that the appreciation in the value of the distributed property should be treated as earnings and profits, holding that the appreciation in value was not realized income to the corporation. The decision below gives effect to the second holding and is not in conflict with the first holding or with the general proposition that a dividend does not result from a distribution of property by a corporation which has no earnings and profits at the time of the distribution. In fact, taxpayer's assertion of conflict (Pet. 13-15) is based not upon the actual decision in *Timken* but on the view that the Sixth Circuit there erred in failing to hold, and to decide the case on the theory, that part of the earnings and profits of the taxable year were applicable against the property distribution.[4]

Palmer v. *Commissioner,* 302 U.S. 63, and *Timberlake* v. *Commissioner,* 132 F. 2d 259 (C.A. 4th), both related to a sale of property by a corporation to its shareholders. In *Palmer,* this Court stated

[4] It was arguable under a pertinent Treasury regulation (see Pet. 14, fn. 18), but not argued by the Commissioner, that the earnings and profits of the taxable year should be proportionately applied against both the cash and property distributions.

that such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among shareholders as the formal declaration of a dividend. However, the sale there was made pursuant to an offer to sell at a price which at the time of the offer represented the fair market value of the property and the Court upheld the transaction as a sale. In *Timberlake* the sale to the shareholders was made at a price equal to the cost of the property to the corporation, which was considerably less than the fair market value of the property, and the sale was held to constitute a dividend to the extent of the difference between the purchase price and the fair market value of the property.

Taxpayer's assertions that the decision below is irreconcilable with *Palmer* and *Timberlake* (Pet. 15-16) rest on a combination of two assumptions—(1) that the court below held that a dividend occurs only if the distribution reduces earnings and profits and (2) that no reduction in earnings and profits results if, as in *Timberlake,* a corporation sells appreciated property to its shareholders at a price equal to the cost of the property to the corporation. The first assumption is incorrect; the court below decided the amount of the reduction in earnings and profits on the facts of this case, not that a reduction in earnings and profits is always a prerequisite to a dividend. The second assumption assumes exactly what the court below held—that the appreciation in value of the property is not chargeable against earnings and profits. On the basis of

taxpayer's own view of the earnings and profits feature of the *Timberlake* situation, that situation differs from the present one only with respect to the cost basis of the property, which in *Timberlake* obviously could not be, and in the present case obviously must be, charged against earnings and profits.[5]

3. The Internal Revenue Code of 1954, P.L. 591, 83d Cong., 2d Sess., mentioned by taxpayer (Pet. 12-13) does not, of course, have any bearing on the instant case. Section 312(a) of the 1954 Code does, however, specifically adopt the premise of the court below that, on a corporate distribution of property other than money or obligations of the distributing corporation, earnings and profits are to be charged with the adjusted cost basis of the distributed property.[6]

That it may have been thought that the law had

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[5] Recovery of the cost basis of the property by a sale to shareholders, as in *Timberlake*, precludes charging the cost basis of the property against earnings and profits. That leaves only the amount of the appreciation in value to be considered. The fact that earnings and profits were not reduced by the amount of the appreciation in value may have been because the appreciation in value was properly to be ignored altogether or, as seems more likely, because the sale (unlike a formal dividend declaration) simultaneously increased and decreased earnings and profits in the amount of the appreciation in value.

[6] The 1954 Code also retains the definition of a "dividend" as a distribution of money or property "out of" earnings or profits (Sec. 316(a)) However, inconsistently with the logical conclusion that a property distribution is out of earnings and profits, and therefore a dividend in its entirety, when earnings and profits are sufficient to cover the cost basis of the distributed property, the examples in the committee reports on the 1954 Code referred to by taxpayer (Pet. 12) reflect that

been settled contrary to the decision below, as taxpayer asserts (Pet. 5-8), does not require review of the decision below by this Court. The language of the applicable statute is controlling. In applying it, two Courts of Appeals—the court below and the Third Circuit in *Commissioner* v. *Godley's Estate,* 213 F. 2d 529—have independently held that, on a distribution of appreciated property to shareholders by a corporation which has earnings and profits available for dividends, the distributing corporation's earnings and profits should be charged with the cost basis, rather than the fair market value, of the property. That conclusion is clearly correct and there is no Court of Appeals decision to the contrary.[7]

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the amount of the dividend to the shareholders would be limited to the amount of the earnings and profits prior to the distribution. It would seem that the language of the 1954 Code would control over the legislative reports, but that is a problem for the future. The Senate Report (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 248) specifically mentions the instant decision and the *Godley's Estate* decision and states that no implication from the enactment of Section 312 (a) is intended with respect to the effects of a distribution of property on earnings and profits and on the shareholders under the prior Code.

[7] Taxpayer refers to other recent cases which have been decided on the authority of the decision below and the *Godley's Estate* decision, including one case (*Equitable Securities Corp.* v. *United States,* decided June 23, 1954 (1954 C.C.H., par. 9530)) in which the Government argued that the amount of the dividend should be limited to the amount of the distributing corporation's earnings and profits. (Pet. 8, fn. 11.) That argument was made for the purpose of protecting the revenue while the instant case and the *Godley's Estate* case were pending on appeal. If the Court denies the petitions for writs of certiorari in these cases, the Government's protective appeal in the *Equitable Securities Corp.* case will be dismissed.

Moreover, the decision below and the *Godley's Estate* decision are but the natural outgrowth of earlier decisions of the Tax Court. The large number of Tax Court decisions cited by taxpayer for the proposition that the law was well settled contrary to the decision below (Pet. 5-6) are cases in which the Tax Court's sole or principal holding consisted of a rejection of the Commissioner's contention that, on a distribution of appreciated property by a corporation to its shareholders, the corporation's earnings and profits are increased by the amount of the appreciation in the value of the property (a contention which would make the fair market value of the distributed property properly chargeable against earnings and profits). Only three of these decisions[8] are contrary to the decision below in that they additionally rejected the Commissioner's alternative contention that the cost basis of the distributed property should be charged against earnings and profits (without increase in the amount of the appreciation in value).[9] The acceptance of that contention by the court below and by the Third Circuit in the *Godley's Estate* case is

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[8] *Congdon* v. *Commissioner*, decided June 1, 1944 (1944 P-H T.C. Memorandum Decisions, par. 44,188); *Dean* v. *Commissioner*, 9 T.C. 256; *Hanan* v. *Commissioner*, decided July 7, 1944 (1944 P-H T.C. Memorandum Decisions, par. 44,273).

[9] *National Carbon Co.* v. *Commissioner*, 2 T.C. 57, which involved the foreign tax credit, is consistent with a conclusion that the fair market value, rather than cost basis, should be charged against earnings and profits. In result but not in theory, so is *Beach Petroleum Corp.* v. *Commissioner*, decided June 26, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,192).

but the natural consequence of rejection of the Commissioner's prior contention that, on a distribution of appreciated property to shareholders, the corporation's earnings and profits are increased in the amount of the appreciation in the value of the distributed property. Indeed, in a case involving depreciated (rather than appreciated) property, the Tax Court itself had previously held (inconsistently with its other decisions mentioned above) that the cost basis, not the fair market value, of the distributed property should be charged against earnings and profits. See *R. D. Merrill Co.* v. *Commissioner*, 4 T.C. 955, 959-963.

CONCLUSION

The decision of the court below is correct, there is no conflict of decisions, and further review is not warranted. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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